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# KAZAKHSTAN: HOW A NEW PETROLEUM LAW CAN FUEL ECONOMIC DEVELOPMENT

*Andrew B. Derman\**

## I. INTRODUCTION

Kazakhstan sits in the belly of the former Soviet Union. The country's oil and gas potential has thrust isolated Kazakhstan onto the economic stage. Kazakhstan has been aided in this regard by the political and economic disruptions occurring within The Russian Federation. The Kazakhstan Government is headed by President Nursultan Nazarbayev, a lifelong member of the old communist hierarchy, who has called for evolutionary reform and has made foreign investment one of the cornerstones of his vision. It remains unanswered whether Kazakhstan can capture the moment and attract significant foreign investment capital in the oil and gas sector. Success in this market will require (1) a realignment of the political structure, which has and continues to control the oil and gas industry, and (2) the establishment of a legal and fiscal regime that offers investors stability and security.

Kazakhstan is a large country covering approximately 2.7 million square kilometers. Of the 17 million people living in Kazakhstan, forty percent are Kazakhs, thirty-eight percent are Russians and five percent are Germans.<sup>1</sup> The country is ethnically diverse with over 100 different ethnic groups. To date, however, Kazakhstan has witnessed little of the ethnic tension which has infected the Caucasian republics and the Central Asian states. Although Kazakhstan is classified by many to be a Muslim country, only fourteen percent of all Kazakhs are Muslim, and religion has not affected the political system as compared to other countries in the area. Because the fundamentalist movement has not had much of an impact in this basically secular state, President Nazarbayev has successfully avoided

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\* Copyright 1993. Mr. Derman is Chief Counsel for Oryx Energy Company, a Director of the Association of International Petroleum Negotiators, and was Chairman of the American Corporate Counsel Association. He currently serves on the Council of the Texas Bar Association International Law Section and is Vice Chairman of the Special Committee on International Energy Law of the American Bar Association's section of Natural Resources, Energy, and Environmental Law. He is a graduate of Temple Law School. This article was presented at the International Energy Law Symposium at The University of Tulsa College of Law, Spring 1993.

1. Country Report on Kazakhstan, Kaleidoscope, 1993 available in LEXIS, Nexis Library, Currnt file.

becoming entangled in Islamic ideology, and nothing exists on the horizon which threatens the successful continuation of this strategy. The issue of language does, however, have the possibility to fracture this apparent cohesiveness.

Although the official language is Kazakh, most of the population speaks Russian. President Nazarbayev has skillfully balanced this potentially explosive issue by declaring Kazakh as the official language, and by mandating that those speaking Russian should not be subject to discrimination. The Kazakhstan Constitution states that the "Russian language is the language of interethnic relations" and the "state guarantees the preservation of the sphere of use of the language of interethnic relations and other national languages, and looks after their free development."<sup>2</sup>

Kazakhstan is viewed as one of the most stable states of the former Soviet Union. This is due predominantly to the presence of President Nazarbayev, a Kazakh. At age 47, he is young, vital and viewed by many as extremely capable and intelligent with an ability to blend far-sighted political vision and pragmatic implementation. President Nazarbayev denounced the anti-Gorbachev coup in August 1991, and he has continued to retain overwhelming support of the populace. Long-term stability is, however, dependent on the adoption of stable political and legal systems. Whether Kazakhstan can maintain its current political stability without the presence of President Nazarbayev is questionable at this time.

In many respects, Kazakhstan and Texas have a lot in common. Both are endowed with rich oil and gas resources, a petrochemical and chemical industry, hard mineral deposits, a strong agricultural industry, and a motivated and highly skilled work force. In the oil and gas area, Kazakhstan produces about 545,000 barrels of oil per day (b/d), of which about 100,000 b/d are exported. Gas production is approximately 8.1 billion cubic meters per year with associated condensate production of nearly 125,000 b/d. Crude oil reserves stand at about 16.3 billion barrels. Natural gas reserves are stated at 1.8 trillion (reserve estimates have been stated to be upwards of 3 trillion meters) cubic meters and condensate reserves are approximately nine billion barrels. In addition to oil and gas, Kazakhstan has substantial hard mineral reserves. It is interesting to note that Kazakhstan accounted for ninety percent of the chrome reserves of the former Soviet Union, 50 percent of the tungsten and lead, and forty percent of the zinc and copper deposits. Kazakhstan was one of the Soviet Union's bread baskets, producing about thirty-three percent of its total agricultural production.<sup>3</sup>

Kadyr Baikenov, Minister of Energy and Fuel Resources, stated in a recent interview<sup>4</sup> that by 1994-96 production will increase to 945,000 b/d

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2. KAZAKH. CONST. (Supreme Soviet Act, 1993) pmbi., para. 8.

3. See generally *Turkey Steps Up Pipeline Pressure as Kazakhs Consider Options*, FIN. TIMES LIMITED, E. EUR. ENERGY REP., Sept. 24, 1993; Rashmi Nehra, *Kazakhstan Has an Abundance of Oil and Other Resources*, BUS. AM., Sept. 6, 1993, at 4; Brian Killen, *Kazakh Oil Output, Exports Hit by Sulphur Problem*, REUTER EUR. BUS. REP., Sept. 17, 1993.

4. *Petroconsultants, Acreage, Laws and Tax*, PETROLEUM INTELLIGENCE WKLY., Dec. 21, 1992.

and that by the year 2010 production will reach 1.65 million b/d. Interestingly, Minister Baikenov predicts that these increased levels of production can be achieved without bringing new fields on stream.

Kazakhstan is dependent on a pipeline system that exports oil from the western portion of the country to Russia and imports oil to the eastern portion of the country from Russia. Kazakhstan operates one refinery located in the western region of the country and two refineries in the eastern part of the country near the population centers. Total refining capacity is about 390,000 b/d. Many potential oil and gas investors have spent hours staring at a map of the region in search of a secure route for an export pipeline. There is no easy solution.

At the moment, all crude designated for export must flow through the Russian pipeline system. The prospect of having to use the Russian pipeline transportation network operated by Transneft to move Kazakhstan oil to market does not warm the heart of many a prospective investor. Furthermore, the current chilly environment could worsen if Transneft is split into separate pipeline entities. In the not too distant future, an exporter may have to enter into a number of separate transportation agreements with the individual pipeline entities.

A great deal of effort has been devoted to a pipeline which would connect production from the Caspian Sea and the Tengiz field to the Russian port of Novorossiysk on the Black Sea. This route has been favored because it is direct; a portion of the not yet built pipeline can benefit from existing sections of pipeline that can be integrated into the new line. A portion of the proposed route would, of course, be laid in Russia, connecting to the Russian port of Novorossiysk as the point of export. Questions as to the security of a line which passes through Russia have been raised, and this concern has been highlighted by the Russian Supreme Soviet's inability to ratify the project.

The sponsors of the proposed pipeline are Oman, Kazakhstan, Azerbaijan and Russia. Each of the sponsors was to ratify the project no later than February 28, 1993. The project has been ratified by all parties except Russia. The reason the Russian Supreme Soviet refused to ratify the project remains a mystery. Several of the Russian hardliners argued that to allow such a project to go forward would only compromise the Russian patrimony in oil and gas. Others argued the economic benefits for Russia are not sufficient to justify approval. It has been speculated that at least some in Moscow have no interest in seeing the pipeline project built at this time. To do so would create additional competition for Russian exports of crude oil and it could ultimately restrict or eliminate Russian exports of Siberian crude that feed Kazakhstan's two eastern refineries. On the other hand, the approval of the Russian Supreme Soviet is typically slow in materializing.

If all the sponsors agree on this pipeline project, financing will still have to be arranged. Oman is reported to be involved in the effort to secure financing. The pipeline is scheduled to be completed three years after construction begins in earnest. In fact, some of the construction has

already begun. Bechtel and Williams Brothers have been retained to manage construction of the pipeline project. Moreover, the associated infrastructure will need to be built or expanded. This is especially relevant with regard to increasing the export capacity at the Russian port of Novorossiysk. It is not clear whether producers will have the opportunity to take an equity and management share in the pipeline. Several companies have expressed an interest in assuming an equity interest in the pipeline project, but so far no oil company has become an equity interest owner.

Both Iran and Turkey are working diligently to encourage the routing of pipeline systems over their territories. A pipeline route over Azerbaijan and Armenia could be connected or looped into the Turkish pipeline that was previously used to export Iraqi oil. This Turkish pipeline proposal would deliver the crude oil to the port of Yumurtalik. Iran has made a number of proposals to assist Kazakhstan with its export problem.<sup>5</sup> Kazakhstan crude could be exported via a pipeline laid in Iran or, alternatively, Kazakhstan oil could be used to feed Iranian refineries located in northern Iran and an equivalent amount of oil could be exchanged or taken at a Gulf export terminal. Discussions regarding exchanges are apparently being pursued by a number of companies contemplating operations in Azerbaijan and Kazakhstan. A dedicated pipeline running from Kazakhstan to an export terminal on the Gulf is not economically justified on the basis of current crude oil projections. This leads inevitably back to the map of the region in search for another solution.

The bubble of enthusiasm over oil and gas opportunities in Russia has burst. This is not to say that the situation is irreversible, but companies are losing interest and enthusiasm is being replaced by critical reticence. Many companies will wait until the business and legal environment solidifies. This situation in Russia has both a negative and positive affect on potential business in Kazakhstan. Since Kazakhstan does not differentiate itself from Russia in the business and legal environment, some companies are likely to group both Russia and Kazakhstan together and to associate the same level of risk with both countries. Moreover, the risk level in Kazakhstan is potentially higher because there is no current transportation export network for oil and gas other than through the Russian pipeline system.

On the positive side, companies are now looking elsewhere, and Kazakhstan has, at least for the moment, captured the imagination of the oil industry. Some companies that have developed sizeable databases and understanding through work in Russia are now attempting to use this knowledge and experience outside Russia, focusing on Kazakhstan. Other companies that decided to wait until the environment settled down before devoting substantial resources in Russia, have looked elsewhere in the former Soviet Union and have been attracted to Kazakhstan. Still, other companies have followed the "lemming mentality" often seen in the oil and gas

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5. Energy Cooperation in Central Asia and the Caucasus, Tehran, Iran (Sept. 1-2, 1992). At this conference, several papers advocated construction of a pipeline system through Iran or trades for Iranian crude to move Kazakhstan crude oil to market.

business and have followed the movement to Kazakhstan because many competitors are looking for opportunities there.

The question remains whether Kazakhstan will be able to capitalize on the present situation and put in place a business and legal regime that will attract real investment in the oil and gas sector. To do so will require the enactment of a body of law that encourages and protects investment. I have every reason to believe that Kazakhstan is committed to a policy of attracting oil and gas investment. But will Kazakhstan be able to create such a pro-investment environment within the tolerance time frame of those oil and gas companies currently looking to invest today? With every passing day, Kazakhstan further delays receiving income from the sale of its oil and gas. The decrease in the net present value of a two or three year delay on oil and gas projects can be quite incredible. Therefore, the oil and gas industry grows increasingly frustrated.

Since Kazakhstan did not obtain its independence until December 16, 1991, the industry is still searching for the map to the labyrinth of doing business in Kazakhstan. Companies' shareholders and stakeholders demand tangible results. How long can most companies wait while sizeable portions of their technical, professional, and managerial staffs are devoting substantial time to studying and analyzing Kazakhstan's oil and gas potential and ascertaining how to do business there? A great sage once pronounced that one should strike while the iron is hot. Kazakhstan iron is made of magma. Kazakhstan needs to seize the moment and move both boldly and expeditiously to put into place a business and legal regime which would attract and protect investment.

## II. THE LAW

I will approach the analysis of the Kazakhstan law with the assumption that comprehensive legislation will be passed which addresses oil and gas. This approach also assumes that the drafters of such legislation will conclude that a patchwork quilt of law will at best produce conflict and ambiguity and will at worst create a system that does not encourage investment. The current patchwork of law includes legislation that was passed prior to the date of independence (December 16, 1991) as well as legislation that was passed after independence. To date, there is no effective law which directly addresses oil and gas. One could analyze the myriad of outstanding laws that indirectly affects this by building a framework with what is currently permitted under the law and extrapolating what rules govern the oil and gas area. I do not believe that such an analysis is truly helpful. To illustrate the existence of conflict, ambiguity, and lack of law, I have herein highlighted those sections of the body of Kazakhstan law that impact the upstream oil and gas sector. It will soon become obvious that a coordinated approach would be most beneficial.

Potential investors, the Government of Kazakhstan, and the oil and gas industry need to look forward, not backward. To become overly embroiled in an effort which attempts to harmonize the present law with a new oil and gas law would be a mistake. No doubt, the oil and gas law

needs to fit into the overall legal scheme in Kazakhstan, but our efforts would yield far greater success if the thrust of our activity focuses on what should be and not what is. Therefore, I have devoted a great portion of this paper to what the law conceptually should be. To provide a framework for this discussion, I have focused on the draft Oil Law that is currently before the Kazakhstan Supreme Soviet.

The draft Oil Law was developed with the assistance of the World Bank and several other independent third party advisors.<sup>6</sup> A number of very able and skilled individuals assisted an extremely capable group of Kazakhs in the development of the draft Oil Law. I believe the drafters of such legislation have created an outstanding foundation upon which to build. The draft Oil Law needs clarification if it is to be the guiding principle upon which substantial investment will be made.

My analysis relies upon English translations of Russian versions of current laws. While I have examined several English translations of many of these laws, I do not feel truly confident that the English translations capture their subtle meaning and nuances. In order to give the reader as accurate a reflection of the law as possible, I have quoted the English translation verbatim in most instances. This device, no doubt in some instances, gives the paper a somewhat stilted style. However, I did not want to add to the confusion by paraphrasing the English translation.

### III. THE CONSTITUTION

The first level of analysis considers the Constitution of the Republic of Kazakhstan as it addresses oil and gas. The Constitution was adopted on January 28, 1993.<sup>7</sup> The Constitution prohibits direct ownership of oil and gas. Article 46 of the Constitution states in its entirety, "[t]he land, its depths, waters, vegetable and animal worlds and other natural resources are within exclusive state ownership. The limits and subjects of exercising, in the name of the republic, the right of ownership to stated objects, are determined by law."<sup>8</sup> If one thing is clear, the Republic of Kazakhstan will retain exclusive ownership over its oil and gas resources.

### IV. THE CODE ON THE SUBSURFACE AND CRUDE MINERAL PROCESSING

The next area of examination focuses on the Code on the Subsurface Resources and Crude Mineral Processing.<sup>9</sup> The Code on the Subsurface was passed on May 30, 1992, some three months after Russia passed similar legislation. The Code on the Subsurface addresses all subsurface operations, not just oil and gas. It has been described as umbrella legislation

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6. The draft Oil Law was developed from 1992 to 1993.

7. Sergei Kozlov, *The Republic Acquires a Constitution*, NEZAVISIMAYA GAZETA, Jan. 31, 1993, at 1.

8. KAZAKH. CONST. (Supreme Soviet Act, 1993) art. 46, paras. 1, 2.

9. LAW (CODE) OF THE REPUBLIC OF KAZAKHSTAN ON THE SUBSURFACE RESOURCES AND CRUDE MINERAL PROCESSING [CODE ON THE SUBSURFACE], adopted May 30, 1992.

from which more detailed legislation will spring. It is questionable whether the Code on the Subsurface clarifies or confuses the situation. The Code does, however, establish by law the jurisdiction of various ministries over extractive and processing operations, perhaps reflecting the drafters' real intention of the Code on the Subsurface. I discuss the Code on the Subsurface and its interaction with the draft Oil Law later in this paper. For now, I will highlight the most important provisions of the Code on the Subsurface as they relate to the oil and gas sector.

Relations relating to the possession, use and disposition of the subsoil and relations relating to the processing of mineral raw material shall be regulated by the present Code and by other acts of legislation of the Republic of Kazakhstan issued in accordance therewith. . . .<sup>10</sup>

. . . .  
 . . . The right of ownership to the subsoil in the Republic of Kazakhstan shall be effectuated by the Supreme Soviet of the Republic of Kazakhstan through the entire territory of the Republic. . . .<sup>11</sup>

. . . .  
 . . . The subsoil shall be granted for use for: 1) geological study; 2) extraction of minerals; 3) construction and operation of underground installations not connected with the extraction of minerals, including installations for the underground storage of oil, gas and other substances and materials, the burial of harmful substances and production wastes, the discharge of sewage waters, and the satisfaction of other needs. . . .<sup>12</sup>

. . . .  
 . . . The subsoil may be granted for use to enterprises with foreign participation and to foreign juridical and natural persons on conditions of a contract or concession. . . .<sup>13</sup>

. . . .  
 . . . The subsoil shall be granted for geological study by agencies of the Ministry of Geology and Protection of the Subsoil of the Republic of Kazakhstan to: (1) enterprises, organizations, institutions, and citizens of the Republic of Kazakhstan on the basis of a project for geological study; (2) enterprises with foreign participation and foreign juridical and natural person on the conditions of a contract or concession.<sup>14</sup>

The Republic of Kazakhstan is to grant deposits of "republic significance" and the local soviets of people's deputies is to grant deposits of "local significance."<sup>15</sup>

"Use" of the subsoil is granted by the Ministry of Geology and "extraction of minerals and use" is granted by either the Republic of Kazakhstan for deposits of "republic significance" and the local soviets of people's deputies for deposits of "local significance."<sup>16</sup>

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10. *Id.* art. 2.1.

11. *Id.* art. 5.2.

12. *Id.* art. 9.

13. *Id.* art. 10.3.

14. *Id.* art. 12.1.

15. *Id.* arts. 13.1, 13.2.

16. *Id.* arts. 13.3, 13.4.



"Juridical and natural persons who have financed geological prospecting work shall have a preferential right to exploit the prospected deposit on conditions of complying with the requirements of the present Code."<sup>17</sup>

Before a contract can be executed, the investor must obtain a "mining allotment" from the Ministry of Geology<sup>18</sup> and the project must be evaluated by the Ministries of Geology, Ecology and Bioresources and Public Health as well as the State Committee for the Supervision over the Safe Conduct of Work in Industry and Mining Supervision.<sup>19</sup>

"The use of the subsoil may be for a term or in perpetuity."<sup>20</sup> However, the right to use the subsoil can be terminated pursuant to an enumerated list of circumstances and in accordance with a specified procedure.<sup>21</sup>

Authority over the granting and regulatory process is given to the Supreme Soviet, local soviets, the Republic of Kazakhstan, the State Commission for Mineral Reserves and the Ministry of Geology.<sup>22</sup>

The results of the geological study of the subsoil of the Republic of Kazakhstan materialized in bearers of information (maps, tables, textual annexes and others) shall be the ownership of the customer which effectuated the financing for the work as a result of which the particular information was received, unless provided otherwise in the contract . . . .<sup>23</sup>

. . . .  
 . . . Geological and other information on the subsoil of the Republic of Kazakhstan irrespective of the sources of financing, shall be handed over without compensation to the Ministry of Geology . . . .<sup>24</sup>

. . . .  
 . . . The realization (or transfer, exchange, sale) of information on the subsoil shall be effectuated by the Ministry of Geology and the Protection of the Subsoil of the Republic of Kazakhstan in the procedure established by the Cabinet of Ministers of the Republic of Kazakhstan . . . .<sup>25</sup>

. . . .  
 . . . Social organizations shall take part in activity directed towards ensuring the protection of the subsoil and the rational and integrated use of mineral raw material in accordance with their charters (or statutes) and legislation of the Republic of Kazakhstan . . . .<sup>26</sup>

. . . .  
 . . . Disputes relating to the possession, use, and disposition of the subsoil and processing of mineral raw material shall be considered by courts and arbitrazh courts in the procedure established by legislation of the Republic of Kazakhstan . . . .<sup>27</sup>

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17. *Id.* art. 13.5.

18. *Id.* art. 15.1.

19. *Id.* art. 14.2.

20. *Id.* art. 19.

21. *Id.* arts. 21, 22.

22. *Id.* arts. 23-27.

23. *Id.* art. 37.1.

24. *Id.* art. 37.3.

25. *Id.* art. 37.7.

26. *Id.* art. 67.

27. *Id.* art. 68.

. . . Transactions which directly or indirectly violate the right of possession, disposition, and use of the subsoil shall be deemed to be void . . . .<sup>28</sup>

. . . .

. . . Persons guilty of concluding the said transactions, and also other violations of legislation on the subsoil and processing of mineral raw material, shall bear disciplinary, material, administrative, and criminal responsibility established by law.<sup>29</sup>

## V. OTHER LAWS EFFECTING THE UPSTREAM OIL AND GAS SECTOR

Many laws currently affect oil and gas operations. Until a comprehensive oil and gas law is adopted, these peripheral laws will continue to impact oil and gas operations. As discussed above, I have noted those laws that impact the upstream oil and gas sector and have very briefly highlighted the most relevant provisions of these laws.

Property can be owned by foreign persons.<sup>30</sup>

Objects of the right of ownership shall be regarded earth, its bowels, rivers and lakes, air space, flora and fauna, other natural resources . . . .<sup>31</sup>

. . . .

. . . The earth, its bowels, rivers and lakes, air space, flora and fauna, other natural resources, historic and cultural monuments shall exclusively belong to the Kazakh SSR . . . .<sup>32</sup>

. . . .

. . . The Kazakh SSR guarantees stability of property relations established in compliance with the present law . . . .<sup>33</sup>

. . . .

. . . The Kazakh SSR guarantees equality before the law of all forms and subjects of property and equal protection of their rights.<sup>34</sup>

Losses caused by government action which terminates proprietary rights shall be ". . . compensated to the proprietor in the full amount by the body which has taken this decision and by the Kazakh SSR."<sup>35</sup>

Confiscation shall only be allowed if accomplished by legislative action.<sup>36</sup> "The Kazakh SSR shall guarantee protection of foreign citizens' and legal entities' properties located in its territory."<sup>37</sup>

Land and other natural resources can be leased.<sup>38</sup>

28. *Id.* art. 70.1.

29. *Id.* art. 70.2.

30. Law of the Kazakh SSR on Property in the Kazakh SSR, adopted December 15, 1990, art. 3.2.

31. *Id.* art. 2.1.

32. *Id.* art. 19.1. *See also id.* art. 24.1.

33. *Id.* art. 23.1.

34. *Id.* art. 23.2.

35. *Id.* art. 23.3.

36. *Id.* art. 23.4.

37. *Id.* art. 23.7.

38. LAW OF THE KAZAKH SSR ON LEASE, adopted Feb. 2, 1990, § 1.

Foreign juridical persons and foreign citizens have the right to engage in business enterprises of their choice provided that such activities are not prohibited by law.<sup>39</sup>

Business activities must be registered.<sup>40</sup>

An entrepreneur can acquire foreign currency at specific auction or State bank according to acting market-rates. "Confiscation of the entrepreneur's foreign currency is not permitted."<sup>41</sup>

"Foreign citizens as well as citizens without citizenship engaged in economic and entrepreneurial activities on the territory of the Kazakh SSR have equal rights with the citizens of the Kazakh SSR with the exception of specific norms to these people adjusted by other legal acts."<sup>42</sup>

The object of foreign investments on the territory of the Kazakh SSR are enterprises, share participation in the property of Soviet juridical entities, share and other securities and such other property as well as the acquired property rights to use natural resources in the Kazakh SSR for carrying out the economic and any such activity on the Kazakh SSR territory . . . .<sup>43</sup>

. . . .  
 . . . Juridical entities with foreign participation including foreign enterprises shall have the right to participate in any forms of economic associations on a voluntary basis . . . .<sup>44</sup>

. . . .  
 . . . Foreign investments shall be allowed in any spheres of economic and other activity except for production of articles of direct military application . . . .<sup>45</sup>

. . . .  
 . . . The property imported to the republic as investments of foreign investors and not intended for sale shall not be liable to customs duties. Personal property of foreign specialists employed at enterprises with foreign participation shall be brought into the republic duty-free . . . .<sup>46</sup>

. . . .  
 . . . In the Kazakh SSR the nationalization of enterprises with foreign participation shall not be allowed. In exceptional cases the property of the enterprise with foreign participation can be requisitioned in the order specified by the law. In this case the Kazakh SSR will undertake to compensate to the foreign investor the losses incurred . . . .<sup>47</sup>

. . . .  
 . . . The Kazakh SSR shall guarantee to foreign investors the right of free transfer abroad of profits from activity and liquidation of juridical entities with foreign participation as well as from selling their share in said enterprises. . . .<sup>48</sup>

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39. LAW OF THE KAZAKH SSR ON FREE ENTERPRISE AND DEVELOPMENT OF ENTREPRENEURSHIP IN THE KAZAKH SSR, adopted Dec. 11, 1990, art. 3.

40. *Id.* art. 10.

41. *Id.* art. 22.

42. *Id.* art. 23.

43. LAW OF THE KAZAKH SSR ON FOREIGN INVESTMENTS IN THE KAZAKH SSR, adopted on Dec. 7, 1990, art. 3.

44. *Id.* art. 8.

45. *Id.* art. 9.

46. *Id.* art. 16.

47. *Id.* art. 25.

48. *Id.* art. 26.

....  
 ... Import and export of the Soviet and foreign currency payment documents and securities shall be regulated by the Kazakh SSR law on currency regulation. . . .<sup>49</sup>

....  
 ... Disputes of the juridical entity with foreign participation with the state organs of the Kazakh SSR as well as disputes between the participants of juridical entities with foreign participation shall be liable to examination in the state arbitration organs, in the courts of the Kazakh SSR or upon agreement by the parties in the court of arbitration under the Kazakh SSR legislation. . . .<sup>50</sup>

....  
 ... A free economic zone in the Kazakh SSR is a specially allocated territory with clearly defined administrative borders and special legal conditions established with the aim of attracting foreign capital, progressive foreign technology and management experience for accelerated social and economic development of the territory of the zone. . . .<sup>51</sup>

....  
 ... On the territory of the free economic zone it is permissible to conduct any economic, financial and other activities of Soviet and foreign legal entities and citizens except for the production of direct military purpose and those activities that are not allowable by the Kazakh SSR legislation. . . .<sup>52</sup>

....  
 ... Any legal entities located outside the zone are entitled to originate their affiliates or new enterprises including joint ventures on the territory of the free economic zone. . . .<sup>53</sup>

....  
 ... The free economic zone is formed by the resolution of the Supreme Soviet of the Kazakh SSR on representation of the local Soviets of People's Deputies based on the opinion of the territory's population. The border of the zone and the term of validity of special legal conditions on its territory are determined by the Supreme Soviet of the Kazakh SSR. . . .<sup>54</sup>

....  
 ... Nationalization of the property of citizens of the USSR, the Kazakh SSR and foreign citizens, enterprises, associations and organizations in operation on the territory of the free economic zone by the state is inadmissible. . . .<sup>55</sup>

....  
 ... Losses incurred to the citizens of the USSR, the Kazakh SSR and foreign citizens, enterprises, associations as a result of groundless interference of the state and other bodies or officials into their activities are liable to be compensated by these bodies. . . .<sup>56</sup>

....  
 ... Soviet and foreign businessmen wishing to establish enterprises, associations and organizations on the territory of the free economic zone or to

49. *Id.* art. 27.

50. *Id.* art. 28.

51. LAW OF THE KAZAKH SSR ON FREE ECONOMIC ZONES IN THE KAZAKH SSR, adopted December 15, 1990, art. 1.1.

52. *Id.* art. 1.2.

53. *Id.* art. 1.3.

54. *Id.* art. 2.

55. *Id.* art. 4.1.

56. *Id.* art. 4.3.

take part in diverse economic projects should apply to the Administrative Council of the zone attaching the documents in accordance with the regulations on the zone. . . .<sup>57</sup>

. . . .  
 . . . Disputes between legal entities and the Administrative Council of the zone are considered in the organs of judicature, state arbitration and arbitration court. . . .<sup>58</sup>

Entities within the free economic zone are given a number of privileges and benefits, most importantly they are exempt "from profits tax from two to five years from receipt of declared profit."<sup>59</sup>

Imported equipment, material, raw materials and other components intended for production and processing on the territory of the free economic zone and the product exported from the zone are not liable to customs duties. The consumer goods imported to the zone for sale inside it are exempted from custom duties partially or completely.<sup>60</sup>

The conduct of geological exploration and the mining of useful mineral deposits requires a license.<sup>61</sup> The procedure for granting such license shall be established by the Cabinet of Ministers of the Kazakh SSR.<sup>62</sup> The Kazakh SSR shall guarantee the stability of this law, equal rights for all enterprises, stable rates of taxes and protection of property.<sup>63</sup>

The "profits tax rate" is set at a minimum of thirty-five percent for Kazakhstan companies.<sup>64</sup> Joint ventures with a thirty percent or more foreign ownership are taxed at a rate of thirty percent, unless otherwise stipulated by agreement or contract.<sup>65</sup> Apparently, this rate was reduced to twenty-five percent, by virtue of a June 30, 1992 law which amended and supplemented this law. (I have not yet seen translation of the June 30, 1992 law.)

A two-year tax holiday exists for all industries, except mineral resources and fishing industries.<sup>66</sup> A sales tax is to be established by the Cabinet of Ministers.<sup>67</sup> A land tax will be imposed.<sup>68</sup> A fifteen percent dividend withholding tax is established.<sup>69</sup>

The United States and the Republic of Kazakhstan have negotiated a tax treaty to avoid double taxation. The Treaty has not yet been ratified.<sup>70</sup>

57. *Id.* art. 8.1.

58. *Id.* art. 8.7.

59. *Id.* art. 13.1.1.

60. *Id.* art. 15.

61. LAW OF THE KAZAKH SSR ON ENTERPRISES IN THE KAZAKH SSR, adopted on Feb. 13, 1991, art. 4.

62. *Id.* art. 20.

63. *Id.* art. 30.

64. LAW OF THE KAZAKH SSR ON TAXATION OF ENTERPRISES, ASSOCIATIONS AND ORGANIZATIONS, adopted on Feb. 14, 1991, art. 4.

65. *Id.* arts. 5.1(b), 11.

66. *Id.* art. 10.

67. *Id.* art. 15.

68. *Id.* art. 22.

69. *Id.* art. 29.

70. *See id.* art. 33.

Non-residents may freely import, transfer and remit from abroad to the Kazakh SSR as well as export, transfer and remit abroad currency values provided that the indicated currency values were earlier imported, transferred or remitted to the Kazakh SSR from abroad or acquired in the territory of the USSR and the Kazakh SSR on a legal basis. . . .<sup>71</sup>

. . . .  
 . . . Non-residents' assets in foreign currency transferred or imported into the Kazakh SSR with observance of the customs regulations or acquired by non-residents in the established order in the territory of the USSR and the Kazakh SSR shall be subject to free entering to accounts and deposits in Kazvnesheconombank and such other authorized banks of the republic and may be transferred without restrictions through serving banks or exported abroad. . . .<sup>72</sup>

. . . .  
 . . . Non-residents may carry out currency operations including purchase and sale of currency values only through Kazvnesheconombank . . . .<sup>73</sup>

. . . .  
 . . . Assets of non-residents in the USSR currency obtained as a result of selling foreign currency to Kazvnesheconombank may be sold back to Kazvnesheconombank for foreign currency and the sales proceeds may be freely transferred or exported back. . . .<sup>74</sup>

. . . .  
 . . . In a free economic zone the rouble and freely convertible currency shall be in circulation. Settlements between legal entities in the territory of the zone shall be performed in any currency upon the parties decision and agreement.<sup>75</sup>

Participants of foreign economic relations of the Kazakh SSR are bound not later than October 1, 1991: to open foreign currency accounts with the Kazvnesheconombank or with other Republics banks which are authorized to keep foreign currency accounts; to transfer all foreign currency deposits located in the outside banks or foreign banks unless otherwise approved by the Republic's government.<sup>76</sup>

To rescind the force in the territory of the Republic of Kazakhstan of all normative acts, passed by organs of the former Union of SSR, on taxation of import and export of goods (work, services), on customs tariffs and barter. . . .<sup>77</sup>

. . . .  
 . . . To prohibit in the territory of the Kazakh SSR any forms of settlements and payments in foreign currency between legal entities, as well as between legal entities and citizens, except for labour pay.<sup>78</sup>

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71. LAW OF THE KAZAKH SSR ON CURRENCY REGULATIONS IN THE KAZAKH SSR, adopted June 13, 1991, art. 14.1.

72. *Id.* art. 14.2.

73. *Id.* art. 14.3.

74. *Id.* art. 14.4

75. *Id.* art. 15.4.

76. Decree by President of the Kazakh SSR To Ensure Independence of External Economic Activities of the Kazakh SSR, issued Aug. 31, 1991, art. 7.

77. Decree of the President of the Republic of Kazakhstan on Organization of the Foreign Economic Activity of the Republic of Kazakhstan for the Period of Economic Stabilization of and Effecting Market Transformations, issued on Jan. 25, 1992, art. 5.

78. *Id.* art. 6.

"The security subjects are property rights, which may be alienated, in particular, the right to development and use of mineral deposits, lease rights to enterprises, constructions, buildings, erections, debt demands, copyrights, invention laws and other property rights."<sup>79</sup> Can a foreign entity who holds a risk sharing contract grant a security interest in its interest in such a risk sharing contract where the foreign entity does not own the hydrocarbons until produced?

The present Law establishes the order of a formation and use of customs tariff, being a system of customs duties, applying when importing to the customs territory of the Republic of Kazakhstan and exporting outside this territory goods and other things, as well as the regulations of imposing customs duties upon these goods and things.<sup>80</sup> While this law likely imposes customs duties on upstream oil and gas operations, exemptions are explicitly contemplated and can be granted pursuant to legislative acts of the Republic of Kazakhstan.<sup>81</sup>

The Value Added Tax (VAT) is set at twenty-eight percent.<sup>82</sup> It is questionable whether VAT would apply to an oil and gas exploration and production venture.

The April 10, 1992 Decree introduced a forty percent export tax on oil and gas.<sup>83</sup> The October 9, 1992 Decree reduced the export tax to thirty percent for oil and twenty percent for gas.<sup>84</sup>

The Ministry of Geology and Protection of Natural Resources by virtue of Decree No. 1034 is given the exclusive right to sell all geological data, that is data owned by the Government and data owned by third party oil companies.<sup>85</sup>

## VI. THE DRAFT OIL LAW

The draft Oil Law<sup>86</sup> establishes a good foundation from which a sound and lasting oil and gas law can be created. The draft Oil Law could be improved without a significant rewrite of the Law and this analysis will highlight some of the deficiencies in the draft Oil Law and offer suggestions for improvement.

To attract capital at the lowest possible cost, Kazakhstan will need to convince investors that its legal regime will allow oil and gas operations to be conducted in an efficient manner and that investments and property

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79. LAW OF THE REPUBLIC OF KAZAKHSTAN ON SECURITY, adopted on Dec. 23, 1991, art. 27.

80. LAW OF THE REPUBLIC OF KAZAKHSTAN ON CUSTOMS TARIFF AND CUSTOMS DUTIES, adopted on Dec. 24, 1991, art. 1.

81. *Id.* art. 17.

82. LAW OF THE REPUBLIC OF KAZAKHSTAN ON VALUE ADDED TAX, adopted on Dec. 24, 1991, art. 6.

83. Decree No. 716 of the President of the Republic of Kazakhstan, issued on Apr. 10, 1992.

84. Decree No. 845 of the President of the Republic of Kazakhstan, issued on Oct. 9, 1992.

85. Decree No. 1034 of the Republic of Kazakhstan Council of Ministers on Regulations Governing the Transfer, Exchange and Sale of Geological Information in the Kazakhstan Republic, issued 1992.

86. The draft Oil Law was tailored by the Kazakhstan Oil Law Drafting Commission to address the perceived political sensitivities of the Kazakhstan Supreme Soviet.

rights will be protected. To do so requires a clear, unambiguous legal regime that meets these objectives. The current state of the law relating to upstream oil and gas is anything but clear. The above discussion of the current law illustrates the need for a well-written comprehensive oil and gas law.

The threshold issue involves the interplay between the Code on the Subsurface Resources and Crude Mineral Processing and the draft Oil Law. Will the draft Oil Law supersede and supplant the Code on the Subsurface Resources? Will this result only occur where the draft Oil Law explicitly so provides? As it now stands, the draft Oil Law and the Code on the Subsurface Resources conflict either explicitly or implicitly in a number of instances. Should we assume that the rule of construction in Kazakhstan is that the law enacted subsequent in time governs, notwithstanding that the subsequently enacted law, namely the Oil Law, fails to explicitly reference this conflict?

In this regard, it is interesting to note that the Decree of the President of the Republic of Kazakhstan<sup>87</sup> rescinds all normative acts of the former Soviet Union, on taxation of import and export of goods. This Decree nullified laws that affected the taxation of imports and exports.<sup>88</sup> Apparently, the President believed such action was necessary or advisable and that without such rescission the enactment of additional legislation relating to import and exports taxes would be potentially in conflict with prior legislation. Perhaps the President felt this was necessary only because the prior legislation was enacted by the former Soviet Union.

Investors will, of course, desire the most stable, least ambiguous regime. It would, therefore, be advisable for the draft Oil Law to explicitly amend the Code on the Subsurface Resources where applicable. I understand that a draft oil and gas law proposed by the World Bank included a provision that stated that the Code on the Subsurface Resources and other legislation regulating oil and gas operations would be effective to the extent that these laws were not in conflict with the oil and gas law. The current draft Oil Law seems to adopt the opposite approach.<sup>89</sup>

## VII. DETAIL

It is proper to title the legislation the "Oil Law of the Republic of Kazakhstan" even though it addresses oil and gas, because the definition of "oil" includes gas. While I believe the English translation of the Russian word "Nyeft" includes both oil and gas, it would perhaps be better to use the word "petroleum" in lieu of the word "oil." The definition of the word "petroleum" is identical to that of "crude," so there would be no real substantive change. The use of the word "petroleum" is clearer (at least in

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87. Decree of President of the Republic of Kazakhstan on Organization of the Foreign Economic Activity of the Republic of Kazakhstan for the Period of Economic Stabilization of and Effecting Market Transformations, issued on Jan. 25, 1992.

88. *Id.*

89. The preamble (not so specified) provides that the draft Oil Law governs ". . . and acts in conjunction with other laws of the Republic of Kazakhstan."



English) since it has the connotation of covering both oil and gas. Moreover, the use of the term "Petroleum Law" is more customary. Perhaps, this is just a matter of translation. Some of my concerns may be created by the lack of a perfect translation. Construction of words is an exacting effort to most lawyers. This is especially true in the oil and gas field where an established body of law is rooted in a highly sophisticated, technologically-oriented industry that is evolving rapidly. I have endeavored to identify those instances where the translation could be the cause of my concern.

### VIII. TWO CONCEPTUAL ISSUES

Now that I have addressed this relatively minor detail I will discuss what I see as the most critical concern. What governmental entities will be authorized to grant rights of ownership over oil and gas interests? Throughout the former Soviet Union, there has been much concern over who can grant/award oil and gas interests and the property interest an investor acquires by virtue of such grant/award.

Several provisions of the draft Oil Law address the granting/awarding of licenses. Article 2(2) provides that the ownership of oil is defined by contract and by the draft Oil Law.<sup>90</sup> Article 2(3) states that an investor has the right to dispose of the produced oil.<sup>91</sup>

Article 4 gives the Government of Kazakhstan the authority to create a "competent body" which appears to have a rather wide-reaching jurisdiction.<sup>92</sup> The competent body, upon the direction of the Government, is given authority to:

[D]efine tracts, fields and types of oil operations . . . conduct direct negotiations . . . declare a competition or auction and its conditions . . . define the forms of cooperation . . . draw up standard contracts to be approved by the Government . . . conduct an outside expert review of the contracts . . . to monitor implementation of the terms and conditions of the contract . . . to conduct negotiations and enter into agreements with the corresponding agencies of any state to obtain rights that secure the possibility of building a pipeline and other means of transport for operations within another state in order to ensure export of oil.<sup>93</sup>

Many questions are left unresolved. How much authority will the competent body have to act without approval of the government? Will the government have to approve any revision to a standard contract that it has previously approved? Exactly what government entity will oversee and approve the actions of the competent authority? What will the approval process entail and how long will the process take?

Article 8 provides that "the procedure for conclusion of contracts shall be defined by the Government of the Republic of Kazakhstan."<sup>94</sup> In summary, the Government of Kazakhstan is given broad authority to regulate

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90. Draft Oil Law, art. 2(2).

91. *Id.* art. 2(3). It does not say that exorbitant taxes may not be imposed.

92. *Id.* art. 4.

93. *Id.* art. 4.1.

94. *Id.* art. 8.1.

the granting/awarding of oil and gas contracts. The local government agencies are only authorized to grant a "land parcel." This authorization is subject to a few restrictions, such as the minimum size and form of a block.<sup>95</sup> Once again, what government organization will approve contracts negotiated by the competent entity? Will oil and gas companies be required to deal with competing, central, government organizations or one government entity? In other words, will the competent body report and be governed by one government entity or will the competent body be a pawn in the competing aspirations of several government entities? The present situation is especially frustrating; will it improve? The draft legislation does not necessarily resolve this confusion.

The Code on the Subsurface Resources only adds to this confusion. Article 12.3 of the Code authorizes the Ministry of Geology and Protection of the Subsoil to issue geological study licenses.<sup>96</sup> Moreover, Article 13.2 provides that the Ministry of Geology is to participate in the "allocation of the subsurface or any use."<sup>97</sup> The Republic of Kazakhstan is authorized by the Code to grant production licenses on "mineral deposits of national significance."<sup>98</sup> Apparently, smaller fields (called "mineral deposits of local significance") can be granted by local soviets of people's deputies.<sup>99</sup> These terms - mineral deposits of "national" and "local" significance - are not defined. Do Articles 13.2 and 13.3 give the Ministry of Geology authority to participate in the granting of all exploration contracts and all development contracts? Since nothing in the draft Oil Law supplants the Code, one could argue that the Ministry of Geology is required by law to grant exploration contracts and has the right to participate in production contracts.

Currently, the Ministry of Energy and Fuel Resources is taking the lead in granting oil and gas contracts on already proven fields. For example, it is the Ministry of Energy and Fuel Resources that negotiated the huge Tengiz project with Chevron. Does the Ministry of Geology have the right to participate in the granting of such a contract? What happens if the Ministry of Geology believes it has not had sufficient influence over such negotiations? What is the role of the competent body? Can the Ministry of Energy and Fuel Resources grant or approve a contract covering acreage that is primarily exploratory in nature, without the approval of the Ministry of Geology? How are approvals to be given? Are two (or more) Government Ministries required to sign such contracts?

The Code on the Subsurface and Crude Mineral Processing exacerbates the confusion and inertia by providing that "[t]ransactions which directly or indirectly violate rights of ownership, disposition and use of the subsoil shall be deemed to be invalid."<sup>100</sup> Furthermore, "[p]ersons guilty of

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95. *Id.* art. 10.1.

96. CODE ON THE SUBSURFACE, art. 12.3.

97. *Id.* art. 13.2.

98. *Id.* art. 13.3.

99. *Id.*

100. *Id.* art. 70.1.

concluding the said transactions, and also other violations of legislation on the subsoil and processing of mineral raw materials, shall bear disciplinary, material, administrative, and criminal responsibility established by law."<sup>101</sup> While including such provisions is understandable and admirable, these provisions do not provide a great deal of incentive to take initiative in an area which has the potential to be politically charged and is both unsettled and evolving. Unless the governing rules for granting/awarding contracts are unambiguous, the responsible government officials will be reluctant to move without clear authority from above and the oil companies will not be satisfied until the contract is full of signatures or has been endorsed by the Supreme Soviet and signed into law.

Moving outside the government ministries, what is the role of the Republic of Kazakhstan Cabinet of Ministers and the Supreme Soviet? Article 23 of the Code on the Subsurface gives the Supreme Soviet significant authority over this process.<sup>102</sup> On another level, what if the local soviets of people's deputies claim that the field is within their scope of authority as being a "mineral deposit of local significance" prior to the Supreme Soviet confirmation of the field as a deposit of "republic significance"?<sup>103</sup> The Law of the Kazakh SSR on Enterprises in the Kazakh SSR, adopted on February 13, 1991, provides that the procedure for granting licenses for exploration and mining of useful minerals shall be established by the Cabinet of Ministers of the Kazakh SSR.<sup>104</sup> What is the role of the Cabinet of Ministers in light of the draft Oil Law?

If this is not confusing enough, Article 14.2 of the Code on the Subsurface requires that before a "mining allotment" (this term is not defined) is granted, the contract shall be evaluated by the Republic of Kazakhstan Ministry of Geology and Subsurface Protection, the Republic of Kazakhstan Ministry of Ecology and Bioresources, the Republic of Kazakhstan State Committee for Oversight of Work Safety and Mining Inspection and the Republic of Kazakhstan Ministry of Health.<sup>105</sup> As the law is currently written, the competent body will be quite busy obtaining approvals from a whole host of other government organizations before it can take action.

In summary, the draft Oil Law does little if anything to expedite and clarify the process for granting/awarding of contracts. Oil and gas companies will be reticent to move forward on any significant project without obtaining both the endorsement of the full Kazakhstan Supreme Soviet and the signature of the President. For example, even though Elf Aquitaine's contract preceded the enactment of the Code on the Subsurface, Elf sought endorsement of its contract from the Supreme Soviet. When it became clear that a full Kazakhstan Supreme Soviet endorsement would be difficult to obtain in the near term, Elf settled for a decree of the Presidium

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101. *Id.* art. 70.2.

102. *Id.* art. 23.

103. This one issue may be ameliorated by virtue of Articles 23.1(6) and 25(9) if the Republic of Kazakhstan Supreme Soviet approves a list of "mineral deposits of republic significance" expeditiously.

104. LAW OF THE KAZAKH SSR ON ENTERPRISES IN THE KAZAKH SSR, adopted on Feb. 13, 1991.

105. CODE ON THE SUBSURFACE, art. 14.2.

of the Soviet. Chevron has obtained presidential confirmation of its contract in principal. Apparently, Chevron will not request endorsement of the full Kazakhstan Supreme Soviet for its contract.

The draft Oil Law needs to do more to clarify and expedite the process for granting/awarding contracts. First, the draft Oil Law must explicitly provide that it controls, regulates, and governs all exploration, development, and production operations and that the draft Oil Law is superior to and supersedes all laws, decrees, and regulations of any kind that are in conflict with the draft Oil Law. Second, the competent body must have a great deal of authority and independence to act without obtaining approvals from many other government entities.

My second concern involves the multitude of government entities charged with overseeing and regulating oil and gas operations. Pursuant to the draft Oil Law, the following government entities are involved in overseeing and regulating oil and gas operations: 1) The Government of Kazakhstan;<sup>106</sup> 2) Local state agencies;<sup>107</sup> and 3) The competent body.

The Code on the Subsurface is even more expansive when it comes to overseeing and regulating oil and gas operations. Pursuant to the Code, the following government entities are involved in overseeing and regulating oil and gas operations: 1) The Government of Kazakhstan Cabinet of Ministers, a host of ministries are explicitly given such authority; 2) The Ministry of Geology and Subsurface Protection; 3) The Ministry of Ecology and Bioresources; 4) The Ministry of Public Health; 5) The State Committee for Oversight of Work Safety and Mining Inspection; 6) Regional Soviets of People's Deputies; 7) District and City Soviets of People's Deputies; 8) Local state agencies; 9) The State Commission for Mineral Reserves.

No doubt, under the rubric of the Government of Kazakhstan, many other ministries will seek to involve themselves in oil and gas operations. It is reasonable to expect that the Ministry of Energy and Fuel Resources will play a role. Moreover, the Ministries of Foreign Relations and Economy will likely try to become involved, as will other ministries. This list does not consider non-government entities, such as citizen groups, that are explicitly discussed in Article 17 of the Code on the Subsurface. Finally, under the Law of the Kazakh SSR on Enterprises in the Kazakh SSR, what role, if any, will the Cabinet of Ministers play?

It is questionable whether the overlapping jurisdiction of so many entities is really in the best interest of either Kazakhstan or oil and gas companies considering investment in Kazakhstan. Efficiency cries out for a substantial reduction in the number of entities that are authorized to oversee and regulate oil and gas operations.

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106. No doubt, the Ministry of Geology and Subsurface Protection and the Ministry of Energy and Fuel Resources, and perhaps other ministries as well.

107. The number of agencies is not defined or limited.

## XI. ANALYSIS OF SPECIFIC PROVISIONS OF THE DRAFT OIL LAW

### *Article 1. Definitions*

It is customary that defined words and terms are capitalized when used in the text. By capitalizing these words and terms, the reader is made aware or reminded that such words or terms have been defined. I suggest that such a methodology be followed.

### *Article 2. Right of Ownership of Oil*

It is absolutely critical that the contractor be given the right to freely export and sell its oil and gas production. The institution of export quotas, export licenses, and/or repatriation regulations should not be raised as impediments to the free export and sale of oil and gas. While Article 2.3 does not raise such concerns, it is a very short, rather non-descriptive provision. Article 2.3 states in its entirety "[t]he right of disposition of oil brought to the surface shall rest with the owner, unless otherwise specified in the contract."<sup>108</sup> Considering the critical nature of this provision, it would be advisable to expand this provision to explicitly address the above issues. Unless investors are absolutely convinced that an issue has been fully addressed to their satisfaction, they will consider the matter somewhat risky and will adjust their economics accordingly.

It is unclear whether this provision supersedes the Law of the Kazakh SSR on Currency Regulations in the Kazakh SSR to the extent that the Currency Law imposes requirements on oil and gas exporters.<sup>109</sup>

### *Article 3. Competence of the Government of the Republic of Kazakhstan*

Article 3.2 permits the Government to mandate that certain acreage is exempt from being used for oil and gas operations. Article 3.2 states if "territories on which conduct of oil operations is temporarily prohibited for reasons of national security, the need to create a strategic reserve, or danger to the environment shall be defined by the Republic of Kazakhstan Supreme Soviet at the representation of the Government of the Republic of Kazakhstan."<sup>110</sup> I assume a decision on exempting acreage will be made prior to the granting/awarding of such acreage and the signing of a contract. If this is the intent of the drafters of this section, a short sentence on point would clarify the matter and limit the risk to prospective investors. No investor wants to find out that all or a portion of its contract area has been declared off-limits, especially if such declaration is issued after hydrocarbons have been found.

Article 3.3 provides that "[n]o legal or physical person may conduct any oil operations in the Republic of Kazakhstan without signing a contract and receiving a license from the Government or an authorized state agency

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108. Draft Oil Law, art. 2.3.

109. Evidently, this provision does not mean that export tariffs cannot be imposed. As discussed above, pursuant to Presidential Decree No. 845 there is a 30% tariff on the export of oil and a 20% tariff on the export of gas. See *supra* note 84.

110. Draft Oil Law, art. 3.2.

on terms and conditions specified by legislation of the Republic of Kazakhstan."<sup>111</sup> Is the reference to "a license" in Article 3.3 the same as "a mining allotment" in Article 14.2 of the Code on the Subsurface? Will the competent body grant this "license" or will it be granted by another government entity? Why are alternative government entities given authority to issue "licenses?" What does the reference to legislation mean, current legislation (if so, cross references would be helpful) or prospective legislation? What role, if any, will the Cabinet of Ministers play in the process of granting licenses?<sup>112</sup>

#### *Article 4. The Competent Body and its Rights and Obligations*

It would certainly expedite the process of moving forward with oil and gas operations if the competent body would be named in the draft Oil Law. As written, another piece of legislation needs to be enacted to name the competent body. As previously discussed, the competent body should be given a fair amount of jurisdiction. The fewer government entities involved, the more efficient the operations will be. Article 4 delineates the jurisdiction of the competent body.<sup>113</sup>

#### *Article 5. Competence of Local State Agencies*

Local state agencies are given broad authority under the draft Oil Law to oversee and regulate operations. This authority is rather unrestricted and could act to impede development operations unless coordinated with the competent body and other government entities responsible for similar functions. Local state agencies are given authority to:

grant land parcels . . . , participate in the development and implementation . . . of the oil and gas sector . . . , monitor the protection of land parcels . . . , halt unauthorized use of the subsurface resources for oil operations . . . , take part in negotiations . . . to resolve . . . socioeconomic and ecological interests of the public . . . , and to . . . receive in full the signing bonus and lease payment . . . from 20 to 50 percent of the bonus from production and royalties.<sup>114</sup>

In addition to problems of overlapping jurisdiction, this provision pits the local government against the central government. Obviously, the local authorities will aggressively seek signing and lease bonuses, as they receive 100 percent of the share of such payments. The central authorities may have a somewhat different view of the importance of signing and lease bonuses and likely will focus more on production bonuses and royalties, where they share in the payment. In this regard, it is interesting to note that Article 8.2 of the Law of the Republic of Kazakhstan on the Payment for Use of the Subsurface gives the Republics 50 percent of such payments to the extent they are derived from deposits of "national significance" and

111. *Id.* art. 3.3.

112. See LAW OF THE KAZAKH SSR ON ENTERPRISES IN THE KAZAKH SSR, adopted on Feb. 13, 1991.

113. See draft Oil Law, art. 4.

114. *Id.* art. 5.

25 percent of such payments to the extent they are derived from deposits of "local significance."<sup>115</sup>

Finally, one could conclude that Article 5 of the draft Oil Law mandates that signing bonuses, lease payments, royalties, and production bonuses are to be paid pursuant to the negotiations and terms of the contract.<sup>116</sup> To require that all these burdens be imposed would severely limit the Kazakhstan negotiating entity's (competent body's) flexibility and might well retard or economically prohibit the exploration and development of certain areas. I suspect that this concept did not come through well in the translation. To clarify this concern, the words "if any" could be inserted after each of the burdens or the sentence could be reworded to ensure that the competent authority has the discretion, but not the requirement to impose these burdens in the contract.

#### *Article 6. Types of Contracts*

Assuming a relatively expansive interpretation of the types of contracts listed, this provision should aid in the attraction of investment. Article 6 states in its entirety:

1. The following types of contracts shall be used in the Republic of Kazakhstan for oil operations: a contract for division of the product; a contract for provision of services; a concessions contract. 2. Depending on the conditions of specific oil operations and other obligations, combined and other forms of contract shall be allowed.<sup>117</sup>

#### *Article 7. Effective Length, Terms, and Conditions of Contracts*

Article 7.1 provides that the "effective length, terms, and conditions of a contract shall be determined by agreement of the parties in accordance with the law of the Republic of Kazakhstan that is in force at the time of signing of the contract."<sup>118</sup> This is an excellent start. The parties should determine the length, terms, and conditions of the contract. I have a concern with the second part of this sentence. Are only laws in force applicable? Will legislation enacted subsequent to the execution of the contract be applicable? If this is the intent of the provision, it should be made clear.

There are potential conflicts within the current legislation with regard to the length, term, and/or conditions as they relate to oil and gas contracts. For example, the Code on the Subsurface (which is explicitly cited in Article 7.2 as a law that is to be followed) states in Article 19.1 that the "use of the subsurface may be for a term or in perpetuity."<sup>119</sup>

Article 7.6 limits contract extensions to situations where "especially complex geological conditions" exist or where "additional work" is neces-

115. LAW OF THE REPUBLIC OF KAZAKHSTAN ON THE PAYMENT FOR USE OF THE SUBSURFACE, art. 8.2.

116. Draft Oil Law, art. 5.

117. *Id.* art. 6.

118. *Id.* art. 7.1.

119. CODE ON THE SUBSURFACE, art. 19.1.

sary.<sup>120</sup> Why limit the discretion of the competent body? It would be advisable to delete such limitations. (I assume the word "contract" should be written as "contractor.")

#### *Article 8. Procedure For Conclusion and Registration of Contracts*

This short article provides that the "procedure for conclusion of contracts shall be defined by the Government of Kazakhstan"<sup>121</sup> and that contracts shall be registered as prescribed by the Code on the Subsurface.<sup>122</sup> The Code on the Subsurface basically appoints the Ministry of Geology as the registering entity. Laws that are to be interpreted in conjunction with other unnamed legislation or that include many cross references often cause confusion with regard to their interpretation. Moreover, the amendment process is made more difficult. Consequently, a uniform single body of law is a desirable objective.

#### *Article 9. Conditions of Oil Operations*

Article 9.2 is subject to misinterpretation. Article 9.2 states in its entirety, "[i]n case of a commercial find, the contractor shall be granted the right to compensation for expenses in accordance with the terms and conditions of the contract."<sup>123</sup> Oil and gas companies will spend time and money looking for hydrocarbons in Kazakhstan for the simple goal of producing and selling the production. What is meant by the phrase "right to compensation for expenses?" Does this phrase relate in any way to Article 13.5 of the Code on the Subsurface, which gives those that have financed and found hydrocarbons "a preferential right to exploit the prospected deposit?" I certainly hope not.

Article 9.2 probably means that the contract, for example, a production-sharing contract, will provide for cost recovery.<sup>124</sup> Unless the "right to compensation for expenses" includes the right to produce, take, and sell the production to recover expenses and earn a profit, no oil company is likely to spend money in Kazakhstan. This provision should be clarified. Alternatively, if the provision does not address the fact that cost recovery features should be included in a contract, the provision should be greatly expanded to clarify exactly what is intended.

#### *Article 10. Size of the Contract Territory and Terms and Conditions of its Return*

Article 10 provides that the blocks awarded shall be "predominately of rectangular form,"<sup>125</sup> determined by the competent authority, and they shall be at least 350 square kilometers in size. "Expansions of the contract

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120. Draft Oil Law, art. 7.6.

121. *Id.* art. 8.1.

122. *Id.* art. 8.2.

123. *Id.* art. 9.2.

124. *See id.*

125. *Id.* art. 10.



territory shall be resolved supplementally or through a separate contract."<sup>126</sup> In addition, Article 10.1 could provide that the contractor and the competent body may agree on how to handle boundary expansions in the contract. Many host government contracts contain provisions addressing the expansion of contractual boundaries in the event a discovered field extends beyond the boundary of the contract.

### *Article 11. Oil Operations in Territorial Waters*

Article 11.1 provides that "oil operations in territorial waters of the Republic of Kazakhstan (seas, lakes, rivers) shall be regulated by special legislation of the Republic of Kazakhstan."<sup>127</sup> This future legislation should be consistent, to whatever extent possible, with the "on-shore Oil Law." To ensure consistency, it would be advisable to have a single law that covers both on-shore and the offshore oil and gas operations. Activities that are predominantly on-shore, but that include operations on or under a lake or river, will have to await future legislation which may delay a project. Perhaps, the draft Oil Law could govern all oil and gas operations, except certain operations relating to activity in the Caspian Sea. Certain operations relating to the Caspian Sea could be further governed by special regulations or by subsequent legislation.

### *Article 12. Right to the Republic of Kazakhstan to Acquire Oil*

Article 12.1 states that the "Republic of Kazakhstan has the priority right to acquire oil from the share of a foreign or national state contractor at world market prices" and the amount, procedure, and currency used shall be stipulated in the contract. The conditions of acquisition are to be determined by the Republic of Kazakhstan.<sup>128</sup> This provision delays the negotiations of a very important and sensitive issue for another day - the contract negotiation stage. It would be helpful to define the term "world market price" to make crystal clear that the price paid will be the price a willing seller will sell the oil and/or gas to the willing buyer, pursuant to an arms length transaction.

### *Article 13. Requisition of and Compensation for Oil*

Article 13.1 states that in the event of "war, natural disaster, or other extraordinary circumstances specified by current law, the Republic of Kazakhstan has the right to requisition part of all of the oil that belongs to the contractor."<sup>129</sup> And that the "Republic of Kazakhstan guarantees the contractor compensation for the oil in kind, or monetary compensation at world market prices in force during the extraordinary circumstances."<sup>130</sup> As written, this provision will concern investors a great deal. The provision

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126. *Id.* art. 10.1.

127. *Id.* art. 11.1.

128. *Id.* arts. 12.1, 12.2.

129. *Id.* art. 13.1.

130. *Id.*

does not address the payment procedure, interest or timing (if in-kind production is substituted), nor the currency used to make payment. Moreover, as in Article 12.1 the term "world market price" is not defined.

At a minimum, Article 13.1 should track the language of Article 12.1's second sentence. This is an extremely important matter and it should *not* be overlooked. Investors will be very reluctant to spend significant sums in Kazakhstan if there is any risk that their production/income stream will be taken without immediate payment in hard currency. In a host of recently enacted laws, the Republic of Kazakhstan has guaranteed that investments and property will not be taken, or if taken, compensation will be paid. Some of these legislative guarantees will be discussed later in the paper in connection with the discussion of Article 29, which addresses such guarantees.

#### *Article 14. State Monitoring of the Conduct of Oil Operations*

For the reasons discussed above, I believe the draft Oil Law should explicitly authorize the fewest possible government entities to monitor, oversee, and regulate oil and gas operations. This provision does just the opposite. Article 14 states in its entirety, "[s]tate monitoring of the conduct of oil operations shall be provided by state agencies (within their competence) in accordance with current law of the Republic of Kazakhstan."<sup>131</sup> It provides that various, unnamed state agencies will have jurisdiction. If left unbridled, nearly all bureaucracies will run rampant. Legislation is necessary to restrain the bureaucracies.

Does the term "current law" mean the same as "present law"? I assume the answer is yes and the translation should be clarified.<sup>132</sup>

#### *Article 15. Rights of Contractor*

Article 15 bestows certain customary rights on the contractor. The contractor has the following rights: exclusive operations, use of the contract territory to build production and social facilities, "use of general facilities and service lines both within and outside the contract territory,"<sup>133</sup> use of subcontractors, disposal of "its share oil (product) and associated components that belong to it,"<sup>134</sup> use of affiliates, preferences regarding extensions of the contract and right to terminate the contract.<sup>135</sup>

It is unclear why the contractor is not just given the right to dispose of its share of oil (oil being a defined term which covers "crude oil and natural gas and also includes hydrocarbons made from crude oil, natural gas, fuel shales, or tar sands"). Does this definition not cover oil, gas, and associated products? Why does Article 15 not use the defined term "oil"?

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131. *Id.* art. 14.

132. *See id.* arts. 20(1), 21(1), 26(1), 29(1).

133. *Id.* art. 15.

134. *Id.*

135. *Id.* art. 15.1.

Instead it states the contractor has the right to "dispose of its share of oil (product) and associated components."

Moreover, this Article should contain a provision that gives the contractor a non-discriminatory right to gain access to the oil and gas export transportation networks for reasonable tariffs. Access to the export network is extremely important and such a provision helps reassure potential investors that they will be able to move their production to market.

In addition, the Article would be improved if it provided that no import taxes, duties, and/or levies of whatever type shall be applied against equipment and machinery brought into Kazakhstan for use in oil and gas operations. Such a provision could also be incorporated into Article 21. This recommendation is buttressed by the Law of the Kazakh SSR on Foreign Investments in the Kazakh SSR, adopted on December 7, 1990, which states that "[t]he property imported to the republic as investments of foreign investors and not intended for sale shall not be liable to customs duties. Personal property of foreign specialists employed at enterprises with foreign participation shall be brought into the republic duty-free."<sup>136</sup>

#### *Article 16. Obligations of the Contractor*

This Article enumerates the obligations of the contractor. The obligations, with a couple of exceptions, are fairly customary. For example, the contractor is obligated to employ world-industry practices, observe the laws of Kazakhstan and international legal norms, follow good safety practices, give preference to Kazakhstan service companies to the extent they are competitive, provide progress reports to the competent body, provide information and access to its facilities to government monitoring agencies, keep certain information confidential; furnish geological and geophysical information as required by the Code on the Subsurface, pay taxes and make other payments promptly; participate in the development of the social infrastructure; preserve facilities of cultural and historical significance, and restore "land parcels" and other natural features.<sup>137</sup>

I have three comments regarding Article 16. First, the contractor must observe the legal requirements of Kazakhstan, and in the absence of such laws must observe "international norms."<sup>138</sup> What exactly is meant by the term "international norms?" I question whether it is advisable to reference a term in such an important law that cannot be more specifically defined. The use of hard-to-define general terms opens the door to arbitrary and capricious actions. As discussed previously, I firmly believe that the draft Oil Law should supersede other related legislation. While contractors are subject to the laws of Kazakhstan, in so far as the Oil Law relates to oil and gas operations, the draft Oil Law should control.

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136. LAW OF THE KAZAKH SSR ON FOREIGN INVESTMENTS IN THE KAZAKH SSR, adopted on Dec. 7, 1990, art. 16.

137. Draft Oil Law, art. 16.1.

138. *Id.* art. 16.

Second, it is unusual for an oil and gas law to explicitly provide that the investor participate in the development of the social infrastructure. Well-run companies will assist in the development of the social infrastructure in the environment they operate. This provision provides that such social participation will be made in accordance with the contract. Obviously, significant, contractually-mandated social spending will affect the project's economics and, in some instances, determine whether a project proceeds.

Third, the last sentence speaks about restoring the "land parcels and other natural features" (which I assume to be the surface) to a "condition suitable for future use."<sup>139</sup> What does this provision mean? Does the draft Oil Law look to the "use" given to the surface prior to operations? Alternatively, is the draft Oil Law mandating "use" of the surface in a prospective sense? *I assume it is the former, but even that is somewhat ambiguous.* A little clarification here or a reference to specific requirements as stated in the contract would be helpful.

#### *Article 17. Right of Ownership of a Trunk Pipeline*

This provision states that "trunk pipelines" may be owned by the state "or other ownership."<sup>140</sup> I assume a "trunk pipeline" is a major export line. The term is not defined and should be. I also assume that the phrase "or other ownership" means that foreign companies can own all or a portion of such "trunk pipeline." Once again, I would encourage clarification. If a foreign company can own a "trunk pipeline," I assume they can also own smaller gathering lines. Why not state that all pipelines can be owned in whole or in part by contractors? Article 17.2 simply states that the "management of a trunk pipeline shall be handled by its owner, unless otherwise specified in the contract."

#### *Article 18. Operation of a Trunk Pipeline*

Article 18 in a general manner addresses some of the operational and safety issues related to "trunk pipelines."<sup>141</sup> Article 18.2 states that "[e]nergy-supply enterprises are prohibited to implement operational measures to restrict prescribed limits on energy consumption without the approval of the owner of the trunk pipeline."<sup>142</sup> The reference to "operational measures to restrict prescribed limits on energy consumption"<sup>143</sup> is not totally clear. Perhaps, the translation could be improved.

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139. *Id.*

140. *Id.* art. 17.1.

141. *Id.* art. 18.

142. *Id.* art. 18.2.

143. *Id.*

*Article 19. Interrelationships Between the Owner of a Trunk Pipeline and Local State Agencies and Freight Shippers*

Article 19's purpose is to protect the "trunk pipeline." Local state agencies are not authorized to intervene in the operational activities of a "trunk pipeline."<sup>144</sup> Employees and special equipment used for "trunk pipeline" emergency situations cannot be diverted to other uses.<sup>145</sup> The underlying purpose of this Article is to protect "trunk pipelines", since they will certainly be the lifeblood of the Kazakhstan economy for many years to come. Article 19.2 appears to address equality of access to the "trunk pipeline" by shippers. Unfortunately, it is not clear.

*Article 20. Currency Transactions*

Article 20.2 should comfort investors a good deal. Article 20.2 states that foreign contractors (this term is not defined) are entitled:

[I]ndependently to dispose of their hard-currency assets received as a result of oil operations in the Republic of Kazakhstan, including transfer, storage, and use of these assets outside the Republic of Kazakhstan, provided that tax obligations are met and other payments under the contract are made; to make settlements with agents and to pay wages in hard currency to resident and nonresident workers involved in the conduct of oil, . . . to carry-out reexport of hard currency.<sup>146</sup>

Article 20.1, however, undercuts Article 20.2. Article 20.1 states that "[t]he procedure by which the contractor and subcontractor may conduct currency transactions shall be defined by current law of the Republic of Kazakhstan."<sup>147</sup> Is Article 20.1 necessary? By virtue of Article 16.1, contractors are obligated to follow the "legal requirements of the Republic of Kazakhstan." If Article 20.1 is not necessary, and it appears it is not, it should be deleted. If Article 20.1 is deemed essential, it should be expanded so that investors will know exactly what is contemplated. Obviously, this Article is extremely important to investors. Its wording should be clear and unambiguous.

Article 20.2 allows contractors to "make settlements with agents and to pay wages in hard currency to resident and nonresident workers involved in the conduct of oil operations."<sup>148</sup> How expansively should this provision be interpreted? Does this article address only personal wages? Alternatively, can a company that is providing labor be paid in hard currency? Can a dirt moving company that is providing labor and equipment be paid in hard currency? Note that pursuant to the Decree of the President of the Republic of Kazakhstan,<sup>149</sup> any forms of "settlements and payments in foreign currency between legal entities, as well as between legal

144. *Id.* art. 19.1.

145. *Id.* art. 19.2.

146. *Id.* art. 20.2.

147. *Id.* art. 20.1.

148. *Id.* art. 20.2.

149. Decree of President of the Republic of Kazakhstan, *supra* note 87.

entities and citizens, except for labour pay” are prohibited.<sup>150</sup> Obviously, this is an important provision and it deserves clarification.

### *Article 21. Customs Procedures*

Article 21.1 summarily addresses customs issues in one short sentence, which says “[c]ustoms procedures shall be enforced in compliance with current law of the Republic of Kazakhstan.”<sup>151</sup> As stated above in connection with Article 15, the draft Oil Law would be improved if it contained a sentence which stated that no import tariffs, taxes, duties, and/or levies of whatever type shall be applied against equipment and machinery brought into Kazakhstan for use in oil operations. Where oil and gas companies act as contractors they do not, generally, pay customs duties, tariffs, or taxes.

As noted previously, under the Law of the Kazakh SSR on Foreign Investments in the Kazakh SSR, adopted on December 7, 1990, “[t]he property imported to the republic as investments of foreign investors and not intended for sale shall not be liable to customs duties. Personal property of foreign specialists employed at enterprises with foreign participation shall be brought into the republic duty-free.”<sup>152</sup> Does the reference in Article 21.1 to “current law” refer to the Law of the Kazakh SSR on Foreign Investments in the Kazakh SSR? And, are all imports and exports relating to oil and gas operations exempt? Can the rules change with the enactment of subsequent laws or does the reference to “current law” prohibit the application of laws not in effect on the date of enactment of the draft Oil Law?

Article 21 talks about “customs procedures”<sup>153</sup> and not customs duties, tariffs, or related taxes. Should a distinction be drawn between procedures, which are to be governed by “current law,” and the imposition of customs duties, tariffs, or taxes? Once again, clarification is necessary.

### *Article 22. Taxes and Payments*

Article 22.1 provides that “[w]hen oil operations are conducted, the contractor shall make the following payments, depending on the type, terms, and conditions of the contract: a signing bonus . . . , a land lease payment . . . , a production bonus . . . , royalties.”<sup>154</sup> As if this is not enough, Article 22.2 states that “the contractor also shall pay the following taxes: a profit tax . . . this rate shall be no lower than the profit tax rate on enterprises as prescribed by tax law . . . , a tax on additional profits (this term is not defined) . . . , other taxes prescribed by law.”<sup>155</sup> The English translation appears to say the contract will contain some, but not all, of the

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150. *Id.*

151. Draft Oil Law, art. 21.1.

152. Law of the Kazakh SSR on Foreign Investments in the Kazakh SSR, adopted on December 7, 1990.

153. Draft Oil Law, art. 21.

154. *Id.* art. 22.1.

155. *Id.* art. 22.2.

enumerated taxes and payments. It would be a terrible mistake to mandate that every contract contain all the burdens enumerated in this article.

The fiscal and tax regime is understandably at the heart of whether investments are made. Investors need to know exactly what taxes and payments will be imposed and the total amount of such levies. Investors will take heart in Article 22.2, to the extent that it provides that the "profit tax rate prescribed under the contract shall not be changed during the entire effective term of the contract."<sup>156</sup> Does this mean that the profit tax rate will be set in the contract or only that the methodology, for determining whether and to what extent profits have been made, will be set by the contract?

Can the Kazakhstan Supreme Soviet delegate to the competent body the authority to set the profit tax? This issue needs to be clarified. Obviously, this is a very critical issue.

Article 22.3 is an extremely positive element of the draft Oil Law. Article 22.3 states in its entirety that "[t]he contractor shall not be subject to taxation by new types of taxes introduced after signing of the contract, except in cases where such types of taxes are introduced in place of existing ones that the contractor must pay under the contract."<sup>157</sup> This sentence will give investors a certain level of comfort that no additional burdens will be imposed. To the extent an investor is not absolutely certain that the tax and fiscal regime is stable, the investor will necessarily build in additional risk into its economics. As a result, the host government (here Kazakhstan) will receive a smaller portion of the total revenue stream or a smaller economic rent.

While Article 22.2 prohibits the profit tax changes (up or down) and Article 22.3 prohibits the introduction of new taxes, all is not stable and secure. Article 22.2 also provides that the contractor is to "pay other taxes prescribed by law."<sup>158</sup> These unnamed taxes can be increased without limit. I would strongly encourage the drafters to consider prohibiting increases in these taxes, as has been done for profit taxes.

To the extent possible, the tax and fiscal regime related to production of oil and gas should be put in place contemporaneously with the draft Oil Law. The drafters of such tax and fiscal regime should have as their overriding premise the establishment of a system which clearly identifies all the taxes and payments due, the exact amount of such burdens, and finally, legislative enactments should provide that these taxes and payments cannot be revised, unless mutually agreed to by Kazakhstan and the contractor.

Kazakhstan might consider following the example of countries like Algeria. To assure the investing oil companies greater fiscal stability, contractors in Algeria, who now enter into production-sharing agreements with Sonatrach (the National Oil Company),<sup>159</sup> are protected against tax

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156. *Id.*

157. *Id.* art. 22.3.

158. *Id.* art. 22.2.

159. See Ghiles, Francis, *Arzew Plant Threatens Overcapacity*, FIN. TIMES LIMITED, NOV. 15, 1983, at 18.

increases. The contractor is given a portion of the production net of the payment of all taxes and burdens on production. Sonatrach is responsible for the payment of all taxes and burdens on production; however, the contractor is only liable for its own corporate income/profit tax. This system offers the contractor maximum comfort and protection from additional tax burdens. Therefore, the investor's risk decreases. Concomitantly, the economic rent for the Republic of Kazakhstan should increase.

#### *Article 23. Accounting and Audit*

Article 23 deals with accounting issues. In summary, international accounting practices are allowed. The books and records can be kept in freely convertible currencies, like the United States dollar, and government audits shall not occur more often than once a year.<sup>160</sup>

#### *Article 24. Transfer of Rights and Obligations*

Article 24 addresses assignments and transfers.<sup>161</sup> Transfers of contractual rights can be made (apparently both asset and stock transfers) with the written consent of the competent body. The contract is to specify the conditions relating to transfers.<sup>162</sup> Article 24.2, somewhat cryptically, provides that “[e]xpenses related to the transfer of rights and obligations and incurred in accordance with Item 1 of the present article shall be borne by the contractor.”<sup>163</sup> To avoid arbitrary and capricious actions, the first sentence of Article 24.1 could be amended to read, in part, “. . . only with written permission of a competent body, such permission shall not be unreasonably withheld.”

Article 24.2 is somewhat problematic. What is meant by the term “expenses related to the transfer?” Is it anticipated that a transfer tax will be imposed? The imposition of a transfer tax would be a mistake. This would be especially problematic if the transfer tax was not explicitly established. This should be clarified. Insignificant expenses relating to the filing of corporate transfer documents are fine, but transfer taxes (especially those that are not explicitly established) would chase away investment or cause prospective investors to supplement their economic return to account for the increased expense and risk. This is especially problematic where the costs can not be quantified and analyzed. Fiscal uncertainty results in an increased risk, which negatively affects the project economics. If a transfer tax is considered necessary by Kazakhstan, it should be explicitly provided. Companies will then know how to run their project's economics. Without such specificity, some companies will not seriously continue with their evaluation and other companies will include a very large transfer fee to be on the safe side which will, of course, negatively effect the eco-

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160. Draft Oil Law, art. 23.

161. *Id.* art. 24.

162. *Id.* art. 24.1.

163. *Id.* art. 24.2.



nomics from the perspective of Kazakhstan. (As the saying goes in the United States, "there is no free lunch.")

### *Article 25. Insurance*

The draft Oil Law contains a remarkably detailed insurance provision. The specified insurance is to be provided by Kazakhstan insurance enterprises.<sup>164</sup> This likely answers the question of why the insurance provision is one of the longest articles in the draft Oil Law. In summary, contractors are required to provide fire and explosion insurance on "property used during oil operations", "fixed capital," "oil brought to the surface," and "oil transported via a trunk pipeline."<sup>165</sup> In addition, the contractor must obtain life and health insurance to protect its workforce and insurance for "ecological disturbances."<sup>166</sup> Contractors are permitted to conclude reinsurance and coinsurance agreements with foreign insurance companies.<sup>167</sup> The contract may require additional insurance coverage.<sup>168</sup> Contracts not supported by mandatory insurance are invalid.<sup>169</sup> Insurance is to "be provided in compliance with laws of the Republic of Kazakhstan and accepted international practice and standards."<sup>170</sup>

Most large companies will want to self-insure. Self-insurance will decrease the cost of the operation and, therefore, be of economic benefit to both Kazakhstan and the contractor. Is self-insurance permitted under Article 25? If not, the provision should be amended to permit self-insurance.

Specific language of Article 25 provides that: (1) because of ownership concerns, it is very difficult to insure linepack or oil moving in pipelines; (2) workers' life and health insurance is dependent on social welfare legislation, which is still being developed; and (3) environmental insurance is prohibitively expensive, if it is available at all.<sup>171</sup> The insurance requirements should be modified to take into consideration such concerns.

### *Article 26. Legal Interrelationships*

This Article provides that "current law" shall govern the conditions of employment for both foreign and Kazakhstan citizens.<sup>172</sup> I do not anticipate problems with this provision. Having said this, the legislation should not unnecessarily burden the operations by imposing rules that would impede the efficiency of finding, producing, transporting, and marketing oil and gas.

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164. *Id.* art. 25.

165. *Id.*

166. *Id.* art. 25.1.

167. *Id.*

168. *Id.* art. 25.2.

169. *Id.* art. 25.3.

170. *Id.* art. 25.5.

171. *Id.* art. 25.

172. *Id.* art. 26.

*Article 27. Alteration and Termination of the Contract*

Article 27.1 provides that any changes to the contract shall be made in writing.<sup>173</sup> Article 27.2 provides that the contract shall terminate as prescribed in the contract.<sup>174</sup> These two articles are clear and not particularly controversial. Article 27.3 talks about “early termination” and permits the contractor to independently dispose of its property in such event.<sup>175</sup> The term “early termination” is undefined and it is not clear why this article draws a distinction between “early termination” and contract expiration for purposes of disposal of a contractor’s property.

Finally, pursuant to Article 27.3 the competent body is give a “priority right” to acquire a contractor’s property in the event of “early termination.”<sup>176</sup> The term “priority right” is likewise not defined and somewhat ambiguous. Does this mean the competent body must not only pay the same price offered by a third party, but must also abide by the same terms and conditions offered by such third party? I assume the answer to this question is yes.

These terms should either be defined to ensure no misunderstandings, or Article 27.3 should be deleted. If deleted, the contract could address these issues.

*Article 28. Grounds for Recognition of Contracts and Licenses as Invalid*

Article 28 provides that the “Government of the Republic of Kazakhstan has the right to deem invalid and cancel a signed contract and/or an issued license”<sup>177</sup> only in the following cases:

“[i]nformation that was submitted by the contractor concerning its financial and technical capabilities and that was of great importance to the signing of the contract and/or the issuance of a license does not comport with reality; and [i]t is determined by a court after a competition or auction that the organizing committee . . . had entered into a secret conspiracy with the contractor-to-be concerning payment of illegal compensation to members of the organizing committee . . . .”<sup>178</sup>

While I wholeheartedly agree with the thrust of this Article, I believe what is important is not what the person reviewing an oil company’s financial and technical capabilities thought was “of great importance,” but rather what a reasonable person in a similar position would have found materially misleading. It is not totally clear from the language of Article 28.1 whether the standard is one of a reasonable person or one of the person or persons who actually reviewed the financial and technical capabilities of the contractor. This sentence should be revised and added to the end of the provision so as to read, “. . . in the competition or auc-

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173. *Id.* art. 27.1.

174. *Id.* art. 27.2.

175. *Id.* art. 27.3.

176. *Id.*

177. *Id.* art. 28.

178. *Id.*

tion; or information was submitted by the contractor concerning its financial and technical capabilities that a reasonable person reviewing such information would have found to be materially misleading.”

Finally, is the “license” referenced in Article 28.1 the same as the “mining allotment” referenced in the Code on the Subsurface? Evidently, from this reference, a contractor will sign a contract and will also need to acquire some sort of license or mining allotment. The procedure for acquiring such a license or mining allotment is not clear.

### *Article 29. Guarantees of the Rights of the Contractor*

Article 29 states in its entirety, “[t]he Republic of Kazakhstan guarantees the contractor protection of its rights in accordance with current law.”<sup>179</sup> Obviously, a state guarantee of this nature is of significant importance to a prospective investor. What does the reference to “current law” mean? What laws are applicable? Will an investor obtain the benefits of prospective legislation, as well?

It is interesting to note, in this regard, that a fair number of Kazakhstani laws address the issue of state guarantees of investment and property. The following laws (there may be more) contain state guarantees: the Law of the Kazakh SSR on Foreign Investments in the Kazakh SSR<sup>180</sup>, the Law of the Kazakh SSR on Free Enterprise and Development of Entrepreneurship in the Kazakh SSR,<sup>181</sup> the Law of the Kazakh SSR on Free Economic Zones in the Kazakh SSR,<sup>182</sup> the Law of the Republic of Kazakhstan on Tax System of the Republic of Kazakhstan,<sup>183</sup> the Law of the Kazakh SSR on Property in the Kazakh SSR<sup>184</sup> and the Law of the Kazakh SSR Enterprises in the Kazakh SSR.<sup>185</sup>

The language of each of these laws is different with regard to state guarantees. In accordance with its preamble, the draft Oil Law (and Article 29) “acts in conjunction with other laws of the Republic of Kazakhstan.”<sup>186</sup> Does the preamble, in conjunction with the reference in Article 29 to “current law”, mean that all the outstanding guarantees (that all differ from one another) need to somehow be harmonized to understand what guarantees are mandated by law? How can this be done with language that is implicitly or explicitly contradictory? The solution to this dilemma is simple. The Oil Law should be a comprehensive law that is superior to and supersedes laws in conflict with it.

179. *Id.* art. 29.

180. LAW OF THE KAZAKH SSR ON FOREIGN INVESTMENTS IN THE KAZAKH SSR, adopted Dec. 7, 1990.

181. LAW OF THE KAZAKH SSR ON FREE ENTERPRISE AND DEVELOPMENT OF ENTREPRENEURSHIP IN THE KAZAKH SSR, adopted Dec. 11, 1990.

182. LAW OF THE KAZAKH SSR ON FREE ECONOMIC ZONES IN THE KAZAKH SSR, adopted Dec. 15, 1990.

183. LAW OF THE REPUBLIC OF KAZAKHSTAN ON TAX SYSTEM OF THE REPUBLIC OF KAZAKHSTAN, adopted Dec. 25, 1991.

184. LAW OF THE KAZAKH SSR ON PROPERTY IN THE KAZAKH SSR, adopted Dec. 15, 1990.

185. LAW OF THE KAZAKH SSR ENTERPRISES IN THE KAZAKH SSR, adopted Feb. 13, 1991.

186. Draft Oil Law, pmb.

While a detailed analysis of such a state guarantee is somewhat beyond the scope of this analysis, the language of the guarantee could be strengthened by mandating that prompt, adequate, and effective compensation shall be made in the currency used by the investor. Compensation should be based on the fair market value of the property (the discounted cash flow method should be used) at the time of requisition and, should such payment not be immediately forthcoming, interest shall apply at a specified rate.

*Article 30. Procedure for Review of Disputes*

Article 30.1 adopts a somewhat customary approach to the resolution of disputes. The parties are, in the first instance, to attempt to resolve their disputes through negotiations.<sup>187</sup> Should the negotiations not prove successful, the "dispute shall be resolved by a court or the Arbitration Court of the Republic of Kazakhstan, or, by agreement of the parties, by an arbitration tribunal."<sup>188</sup>

Prospective investors will demand the incorporation of an independent, international dispute resolution provision. The intent of Article 30.1 appears to satisfy this expectation, however, the language could be strengthened by adding a couple of words to the end of the sentence, so that the sentence would read, in part ". . . by an independent, international arbitration tribunal."

An apparent conflict exists in Article 79 of the Code on the Subsurface Resources. Article 79 directs that disputes be referred to and resolved by "courts and arbitration courts."<sup>189</sup> No mention is made of a mutually agreed upon arbitration tribunal. But the conflict does not end here. The following additional laws contain arbitration provisions which in part conflict with Article 30.1 of the draft Oil Law: the Law of the Kazakh SSR on Foreign Investments in the Kazakh SSR, the Law of the Kazakh SSR on Property in the Kazakh SSR and the Law of the Kazakh SSR on Free Economic Zones in the Kazakh SSR. For the reasons discussed above in relation to Article 29 and Government guarantees, it is nearly impossible to harmonize the laws as they relate to dispute resolutions. Most laws do not allow for independent arbitration, yet some like the draft Oil Law do. Once again, this situation cries out for a comprehensive oil and gas law that is superior to and supersedes all conflicting laws.

As to the details of Article 30.1, I question the desirability of having three arbitrators specified by law. I believe the decision whether one, three, or perhaps more arbitrators should be used, should be left to the contractor and to the competent body, and should be provided for in the contract. The use of one arbitrator will result in a faster and cheaper dispute resolution procedure.

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187. *Id.* art. 30.1.

188. *Id.*

189. CODE ON THE SUBSURFACE, art. 79.

## X. ONE FINAL THOUGHT

The draft Oil Law does not explicitly address contracts that have been executed prior to the effective date of the Law. Are these contracts to be governed by the draft Oil Law? Consideration should be given (if not already done so) to ensuring that previously executed contracts can be readily governed by the draft Oil Law.

## XI. SUMMARY

The draft Oil Law of the Republic of Kazakhstan lays the foundation for a truly superior oil and gas law, that could significantly contribute to the investment of substantial sums of capital in the oil and gas sector. The draft Oil Law does, however, have some deficiencies. These deficiencies can be overcome by making relatively minor modifications. When prospective investing companies feel comfortable with both the language and the implementation of the oil and gas legal regime, they will cease requesting the endorsement of both the full Kazakhstan Supreme Soviet and the President for their contracts. Until then, prudent investors will want their contracts to receive such endorsement in order to elevate their contract to the level of a law of the republic, and, by so doing, alleviate a significant portion of the business and legal risk.

The time is now for Kazakhstan. Oil companies throughout the world are talking about and studying exploration and production opportunities there. Unlike most host governments, Kazakhstan does not now have to work particularly hard to attract interest. The interest is already there. The question is whether Kazakhstan can capitalize on the moment and harness the resources of the oil and gas industry to pull it into the 21st century. The potential is enormous. The Kazakhstan work force is highly educated and hardworking. The Government is committed to attracting foreign investment. Finally, Kazakhstan's resource potential is huge. Kazakhstan currently lacks a legal regime and business climate that is conducive to fulfilling its aspirations and its potential. The expeditious development and production of oil and gas could jump start the economy of Kazakhstan. The oil and gas industry anxiously awaits the creation of a stable legal regime and a healthy business climate.

No doubt some companies will brave uncharted and risky waters in the search for world-class reserves and corresponding profits. Certainly, there are such examples. Chevron, Elf Aquitaine, Birlismis Muhendisler and Burosu (BMB - a Turkish heavy engineering company), Oman Oil Company, and Anglo-Dutch Petroleum have all executed agreements. Chevron and Elf Aquitaine have sizeable commitments and have secured certain government endorsements of their agreements. Other companies, such as British Gas and Agip, are negotiating on specific areas. Still other companies, especially those that are focused on exploration, will wait until the legal regime solidifies before moving forward without the endorsement of their contract by both the Supreme Soviet and the President.

Enormous challenges face Kazakhstan. It has come a long way since its independence in December 1991. The economic transformation has started but has a long way to go. Delays in installing a pro-investment legal regime will retard development. Worse yet, ineffective oil and gas legislation will do more than delay investment, it will chase it away. Because of the enormous sums involved in the oil and gas sector and the associated revenue streams, delays in executing contracts and initiating operations could easily translate into multi-billion dollar losses for Kazakhstan. Kazakhstan has many challenges. Certainly, one near-term challenge involves the creation of a stable, pro-investment legal regime and business climate. In this regard, Kazakhstan has a way to go. The draft Oil Law can be used as the basis for a comprehensive oil and gas law that will be one of the cornerstones of real economic development in Kazakhstan.

